

The Winner is Nonqualified

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In previous newsletters I discussed my research on profit distribution strategies which involved ten case study cooperatives. Historical financial data was entered into the financial simulator along with complete patron equity data and the relevant equity revolvment system. The analysis compared the members' return from the cooperative, net of all tax effects, from the combination of cash patronage and future equity retirement payments. The study focused on the internal rate of return which also reflects the time value of money. The analysis was conducted with and without the assumption that the cooperative retained the Section 199 Domestic Production Activity Deduction (DPAD).

The analysis was originally conducted using the standard corporate tax rate for the cooperative and the high income tax bracket for the member. Coupled with state taxes, this resulted in a total tax rate of 45% for the member and 41% for the cooperative. A Kansas State University study examined the effective tax rates (actual taxes paid as percentage of gross income) for farmers and cooperatives. The results indicated much lower rates of slightly over 9% for the cooperative and 14% for the member. The profit distribution strategies were also examined using those lower tax rates. The cash patronage rates were adjusted to be cash neutral to the cooperative relative to the baseline

Under either tax rate, a nonqualified distribution yielded a higher return to the member relative to a qualified distribution. Even though the cooperative had to reduce cash patronage to make the nonqualified distribution, the member's after tax income was still higher since the member's tax rate was higher than the cooperative's. Issuing cash patronage and retaining funds as unallocated equity yielded the lowest return to the member. When the cooperative retained the DPAD the advantage of nonqualified over qualified increased because the cash patronage did not have to be reduced. That was true under both rate assumptions although the differential for nonqualified was larger under high tax rates. The only ranking difference with the DPAD was that for some of the case study cooperatives, the strategy of cash and unallocated equity was superior to the qualified distribution. The DPAD allowed the same cash patronage regardless of whether funds were retained in qualified or unallocated equity. For three of the ten cooperatives with the longest equity retirement cycles the tax effect of receiving the qualified equity was not worth the time adjusted value of the redemption.

With that small caveat the results are clear. Nonqualified distributions were preferred to qualified distributions and retaining funds as unallocated equity yields the lowest member return. The DPAD further increases the advantage of nonqualified. The study did not consider the alternative of the member retaining the DPAD. I've got one word for you: "nonqualified!"

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